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BIG INNOVATION CENTRE

FRC's Review of the UK Stewardship Code

Thoughts for Change from the The Purposeful Company Steering Group

Draft Working Paper 26.10.17

1. Submission Context

Central to the Government's agenda following the General Election is to 'forge an economy that works for everyone in every part of this country' and at the same time to address the productivity shortfall in the UK economy. The entire investment chain – asset managers, asset owners, and service providers (e.g. investment consultants and proxy advisors) – has a critical role to play in achieving these goals:

- **Asset managers**, through effective stewardship – both engagement and monitoring – can ensure that companies pursue long-term shareholder value rather than short-term profits. By doing so, asset managers can both fulfil their fiduciary duty to their clients – asset owners and savers – and improve the long-term performance of British companies.

- **Asset owners**, through holding asset managers to account on the delivery of their stated approach to stewardship, can ensure that stewardship is not simply a policy but a practice. Asset owners are the ultimate 'regulator' of asset managers by awarding mandates, and they are critical to encouraging asset managers to take stewardship seriously.

- **Service providers** should similarly support asset managers in fulfilling their fiduciary duty to asset owners. For example, investment consultants should help asset owners evaluate asset managers on long-term investment performance and the delivery of stewardship.

There are currently widespread concerns that the UK investment management industry is failing to steward the companies it owns for the long-term, leading to perceptions that it has an excessively short-term focus and, as a result, UK corporations are 'ownerless'. These concerns are serious and threaten the industry's legitimacy, in turn leading to calls to reduce shareholders' influence over firms in favour of employee or customer influence, or insulate management against shareholder oversight. Stewardship not only is central to the legitimacy of the UK investment management industry, but also can improve UK productivity, profitability, investment, and competitiveness – thereby transforming the UK into a 'country that works for everyone'.

A review of the FRC's Stewardship Code (the 'Code') is scheduled for 2018. This is a particularly opportune time to improve stewardship. Good stewardship underpins a key pillar of the Government's proposed Industrial Strategy, 'supporting businesses to start and grow'. A number of components of the stewardship ecosystem are already under review in light of the FCA Asset Management Market Review, the review of the Best Practice Principles for Providers of Shareholder Voting Research & Analysis, the required implementation of the EU Shareholder Rights Directive, and the Competition and Markets Authority Review of Investment Consultants. An integrated approach is required to achieve the best results, and so while the focus of this paper is the FRC's review of the Code, we also highlight connections to other areas of regulation or oversight of the investment chain.

A revised Code should be based on the most rigorous evidence. There is a huge range in the quality of evidence and it is almost always possible to find a study that supports a particular viewpoint. Thus, it is important to focus on the highest-quality evidence, published in the most rigorous peer-reviewed journals, and in many cases distinguishing causation from correlation. A consistent conclusion is that, in the long-run, there is no conflict between a model that seeks to maximise value for shareholders and one that creates value for all stakeholders.

The Purposeful Company is uniquely placed to provide input into this redraft. Its Taskforce has brought together businesses, investors, academics, consultants, and think tanks to develop policies to help transform British business with purposeful companies committed to creating long-term value through serving the needs of society. To reflect the heterogeneity of approaches to stewardship, we have sought to take into account the views of a range of wide range of investors and their representative bodies, both active and passive, pursuing different approaches to and levels of stewardship.

2. Guiding Themes for Code Reform

This section outlines the guiding themes behind our suggestions for reform of the Code. In terms of terminology, in this paper we define:

- *Asset managers* as fund management companies (e.g. Fidelity)
- *Funds* as individual funds (e.g. Fidelity Special Situations)
- *Asset owners* or *savers* as ultimate owners (e.g. a university endowment or a retail investor)
- *Service providers* as investment consultants or proxy-voting agencies (e.g. Aon Hewitt or ISS).

When talking about a generic actor in the investment chain, we use the term 'investment chain entity'.

(a) The Code should reinforce the criticality of an integrated approach to stewardship throughout the investment chain

The entire investment chain – not just asset managers – has a critical role to play in effective stewardship of companies. For example, it is asset owners who are best placed to hold asset managers to account on actually delivering their stated approach to stewardship and reporting relevant metrics. Asset managers have a fiduciary duty to act in asset owners' interests, so asset owners being more explicit about their desire for stewardship is critical in encouraging asset managers to take stewardship seriously. Otherwise, asset managers might think that they are acting in clients' interests simply by prioritising cost efficiency. Indeed, the existing Code states that it applies not only to asset managers, but also asset owners and service providers.[1] However, its current Principles were designed primarily for asset managers and are less relevant for other investment chain entities. For example, Principle 6 on voting activity is not relevant for service providers, who do not vote; Principles 3-5 on monitoring, escalation of engagement, and collective engagement are less relevant for asset owners (unless they are investing directly themselves) or service providers.

Therefore, perhaps unsurprisingly, while take-up amongst asset managers has been good (163 signatories as of July 2017), the Investment Association ('IA') found that under half of asset owners are signatories[2], and only 59% strongly agreed that they had stewardship responsibilities; relatedly, only 31% of asset owners say that their investment consultants raise stewardship issues in discussions with them. The lower relevance of the Code to service providers may explain why all classified in Tier 1 and typically with uninformative disclosures; it is hard to downgrade service providers based on principles

[1] The current Code states that it 'is directed in the first instance to institutional investors, by which is meant asset owners and asset managers' and 'also applies, by extension, to service providers, e.g. proxy advisors and investment consultants'.
[2] 'Stewardship in Practice: Asset Owners and Asset Managers', report by the Investment Association and the Pension and Lifetime Savings Association, September 2016

that are less relevant to them.

The Code should recognise the different stewardship roles played by different types of entity, and how they interact. It should set out clearly how its principles should be applied by different types of entity, with a stronger expectation that all types of entity should be signatories. Implementation of the Shareholder Rights Directive creates an opportunity to locate in one place regulatory oversight of the asset owners, asset managers, and service providers. Encouraging asset owners to increase engagement with their stewardship responsibilities is particularly important, but service providers also play an important role. This paper proposes an overarching framework for principles applicable to the entire investment chain, but with tailored principles applying to different types of entity.

(b) The Code should recognise the diverse role stewardship plays in the purpose of investment chain entities

The current Code has been interpreted as implying a one-size-fits-all level of, and approach to, stewardship. For example, Principle 1, for investors to 'publicly disclose their policy on how they will discharge their stewardship responsibilities' may be interpreted as suggesting that all investment chain entities have the same level of stewardship responsibilities. However, using asset managers as an example, asset managers differ substantially in how they aim to use stewardship to serve clients, and clients (asset owners and savers) – through their choice of funds – differ in the level of stewardship they seek from asset managers.

Some funds focus on "generalised" stewardship: corporate governance, environmental, or social issues on a standardised basis across companies. Other funds focus on "specialised" stewardship: active (or even activist) engagement with management on strategy, leadership, portfolio and so on. Yet others best serve clients through focusing on quantitative analysis or cost minimisation, particularly if stewardship is not their core competency. It may not be cost effective, nor efficient for companies, for all investors to engage regardless of their size – small investors may have insufficient 'skin-in-the-game' to justify the cost, and companies not have capacity to meet every investor. Moreover, even funds committed to stewardship may undertake it in many ways. Engagement can occur through a wide variety of forms (voting, meetings with company executives and directors, collective activism) and on a wide variety of issues (remuneration, strategy, culture). Stewardship can occur through not only engagement but also monitoring – evaluating a company's long-term value and intangible assets and, if necessary, selling shares in companies that prioritise short-term profits over long-term value.

Far from leading to a reduction in the quality of stewardship, the recognition of heterogeneity should actually improve it. Holding funds to a one-size-fits-all benchmark may lead to them focusing on box-ticking; a revised Code could free them to deliver, and report on, the specific forms of stewardship that reflect their expertise and best serve their clients.

(c) Investment chain entities should define their approach to stewardship as part of their purpose, including at the fund level

The starting point for defining an investment chain entity's approach to stewardship should be to establish the role stewardship plays within its purpose. Note that the word 'purpose' does not refer to any moral obligation (although, for example, an asset owner or fund could have social or ethical objectives) – for example, a pension fund's purpose will relate to the way in which it intends to meet its long-term liabilities. The statement of purpose should include the entity's view of the role, if any, that it wants stewardship to play in how it operates. Within asset managers, this purpose needs to be defined at the fund level. This reflects a broader notion than a fund's 'objective', which typically contains only quantitative dimensions and/or is generic (e.g. 'to generate long-term capital appreciation'). Sample purposes are given in Section 5, and can range from index tracking, with stewardship being addressed on a generalised basis, to highly specialised activist investment strategies and engagement. Having defined its purpose, an investment chain entity should then define its approach to stewardship, and explain how stewardship fits into its purpose.

Different funds within an asset manager (e.g. active vs. index funds) will have different approaches to stewardship. However, we must also recognise that the reporting burdens associated with requiring each fund to comply in full with the Code would be excessive. Thus, we recommend that adherence to the Code should still be at the asset manager or asset owner level, but that fund purpose should be defined and reported on at the fund level.

(d) The Code should cover not only stewardship policies but the actual delivery of stewardship, with organisation and reporting tightly linked to the stewardship approach to ensure genuine implementation

As discussed in theme (b), the Code should not evaluate all asset managers according a one-size-fits-all stewardship benchmark. But the Code should be very serious about holding funds to account according to their stated approach. Currently, there are widespread concerns that the Code's tiering is based on the quality of a signatory's Code statements, rather than outcomes. As a result, it evaluates stewardship policies rather than actual stewardship practice.

We believe that a revised Code should ensure that an entity's organisation should be tightly linked to its stewardship approach. For example, asset managers with a policy to take stewardship seriously should ensure that it is fully integrated in the investment process, rather than confined to its 'stewardship department', and its use of proxy advisors is consistent with its stewardship approach. Relatedly, the investment chain entity's reporting should also be tightly linked to its stewardship approach. This will include, where possible, pre-specifying quantitative and qualitative metrics of stewardship that it will report, and supplementing them with case studies of effective stewardship. Ensuring that an entity's stated approach to stewardship is backed up by organisation and reporting will help embed it throughout the entity and ensure that it is not only a policy, but a practice.

3. Components of a New Code

Guided by the above themes, this section discusses components of a potential new Code. The Code currently comprises seven Principles, which are well-established, and have achieved industry buy-in. However, they are very focused on asset managers, and as outlined above should be more tailored to different investment `chain entities. Moreover, the Code could be strengthened by giving signatories an obligation to explain how they have applied the Principles ('apply-and-explain'), to increase the likelihood of genuine adoption, rather than box-ticking, and allow greater transparency to stakeholders.

In addition, the Principles can be reinforced by Provisions and Guidance to provide clarity on how to apply the principles. While the Principles should recognise that the heterogeneity in approaches to stewardship, certain Provisions should be followed by most investment chain entities regardless of their approach to stewardship (e.g., for asset managers, long-term compensation), and these should be applied on a comply-or-explain basis. Guidance would not form part of the comply-or-explain framework, but would provide investment chain entities with further explanation of how the principles should be applied, and would allow the development and propagation of best practice over time.

Figure 1: Components of the new Code

Code component	Applicability	Example	Reporting mechanism
Principles	Any signatory to the code	Defining the approach to stewardship	Apply-and-explain: narrative explanation of how principle is applied
Provisions	Any signatory of the code	Disclosure of voting records	Comply-or-explain
Guidance	Some schedules applicable to all entities, some tailored to specific types	Guidance on the use of proxy advisor recommendations	Supports practice and narrative reporting where relevant

We start with potential Principles for a revised Code. We believe that a common set of over-arching stewardship Principles should be employed across the entire investment chain, with sub-Principles to apply as appropriate for each investment chain entity. These Principles are subject to further review and stakeholder testing, but it is helpful to explore what the approach would look like in practice:

Figure 2: Proposed principles

Principles	
A. Defining the approach to stewardship	An investment chain entity should clearly define the role of, and approach to, stewardship in meeting its purpose
B. Organisation in support of stewardship	An investment chain entity should establish an organisation, governance, and processes to support its stated approach to stewardship, including identification and management of conflicts of interest
C. Reporting on the delivery of stewardship	An investment chain entity should clearly disclose its approach to stewardship and how it has been implemented in practice, including outcomes, in a manner that enables its clients and other stakeholders to judge the effectiveness of the approach

The table overleaf illustrates how these principles could be translated for different types of entity.

Figure 3: Example Code Principles for each investment chain entity to support the three over-arching Principles

Asset managers should…	Asset owners should…	Proxy advisers should*…	Investment consultants should*…
A. Clearly define the role of, and approach to, stewardship in meeting its purpose			
define their approach to stewardship and their policy on how they will discharge their stewardship responsibilities in line with their purpose define the purpose of each fund including the approach to stewardship	define their approach to stewardship and their policy on how they will discharge their stewardship responsibilities in line with their purpose have a clear policy on how stewardship is built into asset management mandates	outline how services they offer help clients fulfil their stewardship responsibilities have a clear research methodology, and, if relevant, their 'house' voting policy avoid making recommendations based on strategic judgements that are the responsibility of their clients	include stewardship considerations when helping clients to develop an investment strategy
B. Establish an organisation, governance, and processes to support its stated approach to stewardship, including identification and management of conflicts of interest			
have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed ensure that stewardship is incorporated in the investment process in a manner consistent with its stated approach embed the approach to stewardship in policies and processes	implement the relevant principles for asset managers to the extent they manage investments directly (see left) have a process for monitoring the performance of asset management mandates that includes consideration of performance against the asset owner's stewardship objectives	have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed develop a clear policy for communication and engagement with issuers to enable both issuers and clients to understand the approach taken subject any screening methodologies (ESG, pay-for-performance etc.) to appropriate independent review and validation	have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed have a framework for helping clients to assess stewardship styles of asset managers have a methodology to include fulfilment of mandated stewardship obligations when helping clients monitor the performance of asset managers
C. Clearly disclose its approach to stewardship and how it has been implemented in practice, including outcomes, in a manner that enables its clients and other stakeholders to judge the effectiveness of the approach			
publicly disclose their approach to stewardship and associated policies, including at the fund level where appropriate disclose appropriate information on their voting record report at least annually on their stewardship activities including at the fund level	publicly disclose their approach to stewardship and associated policies disclose appropriate information on their voting record report at least annually on their stewardship and voting activities	publicly disclose their research and screening methodologies and, if relevant, their 'house' voting policy, and their policies on communication and engagement	include appropriate consideration of stewardship considerations in their reporting to clients

*Proxy agencies and investment consultants would also have separate Codes relating to service quality and professional standards

We set out below the key differences in these principles from the current Code.

Asset Managers

The principles for asset managers are very closely aligned with the current principles within the Code. Key changes are the requirements to:

- define purpose, including approach to stewardship, and report on this, at the fund level;
- ensure that the approach to stewardship is incorporated into the investment process; and
- embed the approach to stewardship in policies and processes.

These changes are designed to ensure that the principles encourage effective and meaningful stewardship, as opposed to superficial or 'window-dressing' stewardship. We have also moved into Provisions the principles relating to escalation, collective engagement, and voting policy, as these are ways of evidencing the alignment of the organisation with the approach to stewardship, and may apply in different ways depending on the asset manager's approach to stewardship.

Asset Owners

Asset Owners generally follow the principles for Asset Managers, unless they delegate responsibility for asset management. In this case, key principles cover how they build stewardship requirements into mandates, and then monitor performance against these.

Proxy Advisers

The proposed principles extend the Best Practice Principles for Providers of Shareholder Voting Research and Analysis ('BPP') in two ways.

First, we add a principle that advisers should avoid making recommendations based on strategic judgements that are properly the responsibility of their clients. Proxy advisers can usefully process information for clients in a way that adds to efficiency of stewardship. However, as emphasised in the BPP, the ultimate responsibility for voting judgements must remain with clients. If proxy advisers stray into making recommendations based on areas of strategic judgement, then this may result in investors out-sourcing judgement. In such cases they could highlight voting items as "For Strategic Judgement".

Second, we add a principle that proxy agencies should subject screening methodologies to appropriate external review (for example by leading academic researchers or other experts in the field) to ensure that they are robust in the context of available evidence. Otherwise, faulty screening methodologies may give rise to ineffective stewardship. An example is ISS's pay-for-performance methodology, which is quite at odds in certain respects with well-established research methodologies.

Investment advisers

The principles for investment advisers aim to ensure that they build stewardship considerations into advice they provide to clients on investment strategy and mandate selection, and then the associated monitoring of mandate performance. This is essential to raise awareness of asset owners in relation to stewardship approaches and obligations – a current gap that was identified in the IA's and PLSA's Stewardship Report 2016.

Provisions

Comply-or-explain Provisions can support the implementation of each principle. Examples for asset managers are given below. Further examples where Provisions and Guidance could help interpret the Principles for each type of investment chain entity are given in Section 5.

Figure 3: Example of supporting Provisions

Principle: An asset manager should define the purpose of each fund including the approach to stewardship

Supporting Provisions:

- The fund board should consider the extent to which stewardship is a relevant factor to the fund's purpose, and if so whether the approach to stewardship involves monitoring or engagement, and whether discipline is exerted through sale or voting
- If the approach involves engagement, the board should consider its form, themes, frequency and scope and the approach to collective engagement
- If the approach involves monitoring, the board should consider the dimensions covered (for example performance, strategy, ESG, short-term vs long-term, financial vs non-financial, and if so what factors)

Principle: An asset manager should embed the approach to stewardship in policies and processes

Supporting Provisions:

- Incentives should be aligned with the asset manager's or fund's stated purpose and approach to stewardship
- Clear guidelines should be established for escalating stewardship activities.
- There should be mechanisms for engaging collectively where that is consistent with the approach to stewardship
- There should be a clear policy on voting and use of proxy advisers

Principle: An asset manager should report at least annually on their stewardship activities including at the fund level

Supporting Provisions:

- Asset managers should pre-specify which quantitative and qualitative metrics it intends to report (not report), and why it considers them material (not material) given its stated approach to stewardship.
- Asset managers should supplement these metrics with case studies giving specific examples of engagement or monitoring (e.g. the analysis of long-term value that led to a divestment decision, or the analysis of long-term value that led to the asset manager holding onto a stake despite poor short-term performance).

4. Further Discussion

Given the above themes and components of a new Code, there remain three outstanding questions. We state and justify our approach here.

1. *Should the Code apply at the asset manager or individual fund level*? The current Code applies at the asset manager level. However, approaches to stewardship differ at the fund level – for example, active and index funds within the same asset manager will commit to different levels of stewardship, and so should be held to different benchmarks. At present, disclosure of an asset manager's overall approach to stewardship does not provide transparency to asset owners at the fund level.

   That stewardship commitments vary at the fund level might suggest that individual funds, rather than asset managers, should be signatories. This would allow, for example, funds competing on stewardship to sign the Code and funds competing on cost not to. However, we do not recommend this approach for two reasons. First, the reporting requirements on each fund would be very high, and this might lead to boilerplate statements. Second, asset managers typically use their aggregate ownership in a company to exert their influence on companies. Having individual funds being signatories could both reduce asset managers' influence, and lead to confusion by companies in trying to understand the approach of their investors.

   We thus recommend adherence to the Code should still be at the asset manager level, with the asset manager developing its overall stewardship policy (e.g. approach to collective engagement, and the circumstances that will lead to an escalation in engagement). However, a fund's purpose, specific approach to stewardship, and reporting against these approaches, would be at the fund level. In particular, alongside its investment objectives, each fund should clearly state its approach to stewardship (potentially cross-referencing the asset manager's principles), thus creating transparency for asset owners at the fund level.

   In light of the FCA's desire already to improve definition of, and reporting on, objectives we do not view this is overly onerous, provided that overall Code reporting obligations were held at the asset manager level. Since fund objectives are currently defined at the fund level, stewardship approaches can also be defined at the fund level, and so the burden should not be onerous – similar to an ESG fund's disclosure of its screening approach. Indeed, ESG statements are often across an asset manager, rather than fund level, but such statements are only meaningful if asset owners know how the screening applies to each individual fund. Similarly, just as funds report their historic performance, with accompanying commentary, at the fund level, they can also do so with their performance on stewardship.

2. *Should the Code require a minimum level of stewardship*? The current Code's tiering structure requires an asset manager to demonstrate (or at least report) a minimum level of stewardship – if it remains in Tier 3 after six months, it is removed as a signatory.[3] However, if the Code's

[3] Tier 3 has since been discontinued in August 2017.

primarily goal is to serve savers, it should recognise that certain funds may best serve savers by not engaging in stewardship, but simply providing low-cost access to the equity market. Under this argument, the Code should not tier (or hold funds accountable for) demonstrating a minimum level of stewardship, but a level of stewardship consistent with its stated approach.

Despite the heterogeneity of different approaches to stewardship, we do recommend that the Code continue to require a minimum level, since it is a Stewardship Code rather than a Savers' Code. Funds that believe that they can best serve savers by focusing on cost rather than stewardship can simply choose not to sign the Code. They would have a requirement in supporting regulation to explain their alternative strategy (as under FCA Conduct of Business Rule 2.2.12). However, for funds that do prioritise stewardship, the Code should recognise the different approaches. We believe that this 'hybrid' approach avoids both holding all funds to a one-size-fits-all benchmark and also being seen as a backwards step by dropping the requirement for a minimum level of stewardship.

3. *To what extent should the Code address wider public policy interests?* There is currently a crisis of trust in UK business. Coupled with the urgent need to raise productivity, this is leading Government to look closely at aspects of Corporate Governance and Industrial Strategy. Given the influence and agility of the Code, it is a natural mechanism for implementing reforms without complex and time-consuming legislation.

   However, our view is that implementation of public policy initiatives via the Code that were seen to undermine saver interests would be fatal to its credibility. The great strength of the Code has been its ability gradually to cement shifts in opinion as to what constitutes good investment practice. The comply-or-explain framework relies on policing by consent. If a majority of asset managers felt that measures were being imposed through the Code that were damaging to their interests, then the Code would immediately lose credibility. A situation where it became the norm for asset managers not to comply with several Code provisions would undermine its legitimacy. This would suggest that very specific quasi-regulatory provisions where there is neither evidence for their widespread efficacy nor asset manager or saver support should not be implemented via the Code.

   Therefore the Code should remain focused on measures that foster the delivery of long-term returns to savers and asset owners, rather than explicit consideration of other stakeholders, or a mandated level or form of stewardship. Thus, the primary purpose of the Code is to ensure that funds deliver long-term saver returns – yet, the most effective way of doing so is through stewarding a company's long-term value, which in turn involves serving stakeholders.

5. Application of the Code to Different Entity Types

This section discusses the application of the overarching principles of Section 3 to different types of investment chain entity. We start with a discussion of both Principles and potential Provisions for asset managers, as in many ways this is the central and most complex grouping for the Stewardship Code. Asset owners will often either adopt the same Principles as asset managers, if they manage assets directly, or will delegate responsibilities to asset managers. We therefore focus in Section 5.2 on specific Provisions that may be most relevant to asset owners. Finally, we turn to service provides in Section 5.3, again focussing on considerations that might inform Provisions for that group of entities.

5.1 Asset Managers

This section discusses the application of the overarching principles of Section 3 to **asset managers** (and asset owners to the extent they manage assets directly themselves).

A. Defining the approach to stewardship
An investment chain entity should clearly define the role of, and approach to, stewardship in meeting its purpose

We intentionally use the word 'purpose' as opposed to 'objective' to highlight a broader description of the funds role in meeting an asset owner's or saver's purpose than is typical of current fund objectives. These purposes may differ widely across funds and may include, but not be limited to, some combination of the following:

- Benchmarking indices at low cost, thus providing cost-effective equity market exposure to savers – savers who might otherwise consider only savings accounts, given the fees associated with equity investing.
- Screening in (out) of certain socially responsible (irresponsible) stocks, for savers whose long-term interests include not only financial returns but a social mission.
- Regular engagement with companies, to improve their long-term performance and thus the fund's long-term return to savers.
- Activist investment – seeking undervalued companies with an opportunity to release value through change of strategy, leadership, portfolio.
- Focusing on stock-picking – trading stocks according to their long-term growth prospects and intangible assets (rather than short-term earnings) – but rarely engaging, except in "intensive care" situations, because the fund's expertise is in long-term valuation rather than activism.
- Implementing a trading strategy based on statistical arbitrage, e.g. momentum (buying past winners and selling past losers), to give investors exposure to this strategy at lower cost than they could do to themselves.

Disclosing a broader purpose of the fund, including the approach to stewardship, creates greater transparency for asset owners and savers, and therefore creates greater accountability for funds in how they deliver returns to clients, and in particular accountability for following through on the advertised approach to stewardship. A clear statement of purpose, to which funds can be held accountable, will also help avoid short-term action to reduce costs that is not in savers' long term interests. For example, an asset manager devoting senior management time to contribute to industry consultations on engagement, or paying the membership fee of the Investor Forum, might not clearly serve savers as such actions are costly. However, if the asset manager's purpose involves collective engagement, it will undertake such activities without the need for a calculation on the likely impact on savers. Accordingly, Principle A requires a fund to state its purpose, while at the same time allowing for heterogeneity in purpose.

A fund's purpose in turn provides guidance on its approach to stewardship – how it intends to improve the long-term performance of the companies that it engages in. Stewardship is not the same as purpose, since a fund's purpose may involve dimensions other than stewardship (e.g. the use of SRI screens), and indeed stewardship may not be central to some funds' purpose. However, stewardship should be tied to purpose – how a fund intends to improve the long-term performance of its investee companies should be tied to how the fund intends to generate long-term returns to savers. In turn, an investor can engage in stewardship through two main ways, engagement and monitoring. These are described in more detail on p63-64 of The Purposeful Company's Policy Report, but are summarised briefly here.

The first stewardship mechanism is **engagement/voice**. This involves encouraging change in a firm's policies. In turn, engagement can differ according to the following (non-exhaustive) ways:

- **Form** of engagement. A fund may:
  - Vote for or against management
  - Have private meetings with, or write private letters to, management or directors
  - Act as an investor sounding board to management
  - Engage publicly and in a potentially confrontational manner, e.g. call for management to divest certain assets
- **Theme** of engagement. While the actual theme will depend on a company's particular circumstances, different funds may prioritise different general themes to engage along.
  - The IA's Stewardship Reporting Framework lists the following potential issues: Board and Director Related, Strategy, Remuneration, Capital Structure, Reorganisation (including M&A), Accounting and Audit, Environmental and Sustainability, and Social
  - Complementary to some of the above, a fund might prioritise holding company directors accountable for delivering on their Section 172 responsibilities to stakeholders
- **Frequency** of engagement
  - Some funds may engage only in 'intensive care' situations, where a company is in serious trouble.
  - Other funds may engage with companies routinely, as a matter of course.
- **Scope** of engagement. Some funds may engage alone, and with specific companies in isolation. Others may
  - Engage **collectively with other investors**. The Investor Forum currently has an established framework for collective engagement that addresses legal issues.
  - Engage at an **industry level**. This may involve several asset managers meeting with the main industry players and discussing long-term industry opportunities (risks) and how to capitalise on (address) them. Examples include BankingFutures and the

Investor Forum's engagement with the apparel sector (which emerged from its collective engagement with Sports Direct in 2016).

- Engage at an **economy level**. Investors may be active contributors to IA workstreams or initiatives such as the Executive Remuneration Working Group, or engage with policymakers on how to promote superior stewardship.

As discussed earlier, the relevant engagement mechanisms will differ across funds, hence the importance of the revised Code allowing for a heterogeneity of different approaches. For example, collective and industry engagement may be particularly relevant for index funds.

The second stewardship mechanism is **monitoring/exit**. This involves evaluating a company's long-term growth prospects and intangible assets, and selling a company if both are weak – potentially because the company is instead prioritising short-term earnings. Exit is sometimes seen as the antithesis of stewardship, and a 'patient' investor who never sells is seen as the model one, but this is not supported by any evidence. A 'patient' investor who never sells – regardless of a company's delivery of long-term value – will not hold the company to account. Thus, the company can pursue short-term earnings to pump up the short-term share price, without fear of the investor selling. However, an investor who monitors the company's long-term prospects will sell its stake in a company that focuses on short-term earnings, thus deterring myopic behaviour in the first place. For further detail, see the *Harvard Business Review* article 'The Answer to Short-Termism Isn't Asking Investors to Be Patient.'

Put differently, what matters is not an investor's *holding period* – whether it is long-term or short-term - but its *orientation* – whether it bases its sale decisions on long-term or short-term value. Thus, an investor who engages in stewardship through monitoring/exit should describe how it intends to ensure that it has information on long-term value. This may involve regular meetings with management, ensuring it has a large stake to make it worthwhile to monitor long-term value, and holding management accountable for reporting intangible assets (see our separate Reporting submission).

Finally, we should stress that having a clear approach to stewardship is in asset managers' interest, rather than a burden. It will help asset managers retain competitive differentiation in an industry that is becoming increasingly commoditised. Instead of competing on fees, asset managers will compete on stewardship. Indeed, as the trend towards index investing continues apace, the more sophisticated and deeper stewardship a truly active manager can bring, the more it will be able to maintain differentiation. Equally, index funds will retain legitimacy through strong levels of generalised stewardship on ESG matters and through participating in active engagement on specific stewardship matters.

B. Organisation in support of stewardship

An investment chain entity should establish an organisation, governance, and processes to support its stated approach to stewardship, including identification and management of conflicts of interest

Having defined its approach to stewardship, an asset manager's organisation should flow from it. Principle B requires a fund to ensure that stewardship is incorporated in the investment process in a manner commensurate with its approach outlined in Principle A. There is a concern that stewardship is sometimes confined to the 'stewardship department' of an asset manager, and the fund manager responsible for investment decisions, or company meetings, may ignore the stewardship department's recommendations. Relatedly, in some asset managers, the stewardship department may focus on generalised rather than specialised stewardship, be small, comprise mainly junior staff, and be seen principally as a cost centre.

If a fund has stated that stewardship is a priority, then it must ensure that it is indeed embedded in the investment process. This will involve stewardship being a central duty of the fund managers involved in stock selection, even if they are supported by a central team, and adequate resources being devoted to stewardship. Moreover, the specific nature of stewardship that the fund intends to pursue should be reflected in how it is organised. For example,

- If the fund has stated that it will meet with management regularly, it should ensure that it has the legal resources to ensure that fund managers understand what information can and cannot be shared in meetings (since, in the absence of clarity, they will default to a position of not receiving information).
- If the fund has stated that it will engage collectively, then the asset manager should be part of the Investor Forum, or explain how it intends to engage collectively if not.
- If the fund intends to engage at an industry-level, then the asset manager should be actively involved in industry-wide consultations.
- If the fund has stated that voting is a key channel of engagement, it should disclose the providers of shareholder voting research that it uses, whether it takes recommendations from that provider, whether recommendations are standard or bespoke, and the extent to which it uses external versus in-house recommendations (including the frequency with which it goes against the provider's recommendations).
- If the fund has stated that it will use socially responsible investing ('SRI') criteria in its stock selection, it may choose to form an external advisory committee to provide independent input into its approach, particularly given the ambiguity in defining what constitutes good SRI (e.g. whether companies that make genetically modified crops satisfy the criteria). The minutes of such meetings could be made available to savers. Royal London Asset Management's five sustainable funds are an example of a potential implementation.

C. Reporting on the delivery of stewardship

An investment chain entity should clearly disclose its approach to stewardship and how it has been implemented in practice, including outcomes, in a manner that enables its clients and other stakeholders to judge the effectiveness of the approach

The fund's reporting should be tightly aligned to its stated approach to stewardship. To give an example of how such alignment might be achieved, a potential spectrum of fund approaches is in Figure 4 with the associated reporting metrics in Figure 5. Both are adapted from The Purposeful Company's Policy Report; additional potential metrics are given in the IA's Stewardship Reporting Framework.

Figure 4: Spectrum of approaches to stewardship

Speculative	Index, passive	Active
• Tactical shareholder	• Long-term shareholder	• Fundamentals-driven shareholder
• Trading decisions driven by assessment of short-term stock returns	• Formulaic trading to minimise tracking error	• Trading decisions driven by assessment of long-term value. Ignore short-term stock returns or profits
• Focused on predicting market sentiment and exploiting arbitrage opportunities	• Focused on providing savers with low-cost exposure to equities	• Focused on finding firms with long-term potential and helping them achieve it
• Generally short-term holdings	• Only trade to maintain index weights	• Likely to have long-term holdings, but may not – key factor is trading decisions based on long-term value
• Diversified positions to maximise liquidity	• Fully diversified	• Concentrated positions
• Limited stewardship. Do not wish to receive inside information as this will restrict ability to trade	• Stewardship through voting. Activities likely to be general (board structures, pay norms) than company specific (strategy, leadership)	• Active engagement on specific issues (strategy, leadership). Willing to receive inside information if helps engagement. Monitors long-term value to drive trading decisions

Figure 5: Reporting metrics and link to stewardship approach

Metrics	Speculative	Active
Portfolio size	70-80	20-30
Portfolio concentration	Low	High
Tracking error / active share	Low	High
Benchmark	Market	Unconstrained
Turnover	High	Low
Interactions with management	Low	High
Resources devoted to stewardship	Low	High
Correlation of voting with proxy advisors	High	Moderate
Stock lending	Unconstrained	Constrained

There are three points to note:

- No single metric or set of metrics will adequately capture whether a company is delivering on stewardship. A narrow attention to specific metrics (e.g. low turnover) will encourage box-ticking to manipulate that metric.
- Even for metrics that are relevant to most funds, the same metric may be interpreted in different ways. For example, a short average holding period may be considered undesirable for a fund aiming to steward through long-term engagement, but not one who stewards through

monitoring/exit. A high tracking error or active share is inconsistent with an index fund aiming to track a benchmark, but is consistent with active stock-picking.

- Some metrics should be reported not just quantitatively, but also qualitatively. For example:
  - The resources devoted to stewardship need not simply be headcount, but narrative discussion on their seniority and involvement in the investment process.
  - The voting record need not simply be the frequency of times that a fund votes with management, or with proxy advisor recommendations, but the extent to which the fund considers proxy advisor recommendations and the grounds for deviation, and the extent to which the fund engages with management prior to voting. The fund could also describe whether and why it signals its pre-AGM voting intentions, and whether and why (not) it discloses its votes and rationale for voting post-AGM.
  - Interactions with management should not only report the frequency of management meetings, but also the seniority of the individuals engaging (at both the fund and company) and also the theme of engagement. The latter should then be evaluated versus the fund's stated priorities. The IA's 2014 report on 'Adherence to the FRC's Stewardship Code' found that remuneration was the main theme of actual engagement, even though it only ranked fifth in asset managers' stated priorities.
  - A fund that intends to engage collectively could provide qualitative details on its engagement with other investors in specific company situations or general Stewardship and Strategy Meetings (recommended by the Investor Forum), collaboration with industry associations, and contributions to industry consultations.

Moreover, the set of metrics that will be considered material will differ across funds. For standard metrics that a fund considers not material, and chooses not to report, it should explain why.

- A fund that intends to steward through monitoring/exit may choose not to report turnover, since there is no clear 'target' level of turnover. Realised turnover will depend on how companies behave - if most companies end up focusing on the long-term (short-term), an effective monitoring strategy will involve low (high) turnover. Instead, the fund might report qualitatively on the process by which it obtains information on a firm's long-term value and ensures that any divestment decisions are driven by these considerations rather than short-term profit. Such reporting would be less relevant for a fund that stewards through long-term engagement, or an index fund.

These qualitative and quantitative metrics should be supplemented by case studies of both engagement and monitoring. The IA's Stewardship Reporting Framework suggests that case studies of engagement include the name of the company (where possible), a summary of the issue, who instigated the engagement, the process of the dialogue, and the outcome of the engagement. In addition, case studies of effective monitoring could also be reported. This may involve reporting on (potentially anonymised) cases in which a fund divested the holding, and an explanation of the analysis of long-term value that led to this decision. Conversely, it may involve reporting on cases in which the fund held onto a stake, despite poor-short term performance, due to its analysis of long-term value.

5.2 Asset Owners

Many of the principles for asset owners would apply in a similar way as for asset managers. In this section we consider specific aspects to be considered as potential provisions for **asset owners**:

- The Statement of Investment Principles should be specific about asset owners' stewardship expectations, such as the degree to which they wish stewardship to be exercised, time horizons, and benchmarks, and basis of incentives (e.g. a balance of fixed fees and incentives linked to long-term performance). It could also include the criteria on which the asset owner will evaluate the asset manager and potentially switch to a competitor, and the bases on which it will not (e.g. short-term performance).
- Asset owners could have a 'covenant' (informal, not a legal document) of how they will structure and govern mandates. For example, the Environmental Agency Pension Fund's covenant states what they expect of asset managers, and what asset managers should expect from them.
- The Risk Register for pension funds should be broadened. Currently, it contains issues such as interest rate projections (which may affect optimal stock-bond allocation), but could extend to other items, such as the risk of climate change, ageing population etc.
- Imposing reporting requirements on asset owners (e.g. the overall carbon neutrality of their portfolio) will create demand for such information from asset managers.
- Asset owners could disclose which investment consultants they use, and the role they play in defining and monitoring mandates. Such disclosure would mirror asset managers' disclosure of their use of proxy advisors.

A key class of asset owner is pension funds, and the FRC could work with The Pensions Regulator, Pensions and Lifetime Savings Association, and the Association of Member Nominated Trustees to develop appropriate principles.

5.3 Service providers

This section discusses the application of the overarching framework of Section 3 to service providers, specifically looking at some Provisions that could be developed to support the overarching principles.

Turning to service providers, different principles apply to investment consultants and proxy advisors. **Investment consultants** play a critical role in helping asset owners choose asset managers. However, there is a widespread concern that they choose mandates based on short-term performance and pay insufficient attention to stewardship. Potential provisions follow below:

- Investment consultants should establish a process to help their clients develop stewardship principles and appropriate measurements to factor into investment mandates.
- Investment consultants should put practices in place to ensure that they monitor funds' long-term performance and delivery of stewardship versus their client's stated approach, and report on how they have done this.
- Investment consultants should ensure that the stated stewardship approach of the fund matches the preferences of the asset owner, and report on how they have done this.

- Investment consultants should disclose how they are paid (e.g. whether it is on the long-term performance of the funds they recommend), and how they manage potential conflicts of interest that may arise.

Proxy advisors are increasingly influential, with evidence showing that their recommendations have a causal effect on voting outcomes.[4] Their influence will only continue to grow, with the increasing move from active to index investing. While index funds do not automatically follow proxy advisor recommendations, they rely on them to a reasonable degree, given their internal voting resources are spread over thousands of companies, and given that they tend to focus on generalised stewardship, where proxy agency analysis can be particularly helpful. However, there is the risk that proxy advisors themselves, being spread over thousands of companies, may lead to 'one-size-fits-all' recommendations. Moreover, there need to be clear protocols to avoid accusations that proxy advisors who offer consulting services to companies may be biased towards those companies in their recommendations.[5] There are also concerns that proxy advisors are under-resourced (particularly at the senior level) to cover the large number of companies they issue recommendations on.

Anecdotal market evidence suggests that proxy advisors are not well equipped to apply rules in a situation that requires strategic judgement. A good example is executive pay, where design of the pay system should be linked to strategy, and non-standard features may be appropriate in certain circumstances. This could also apply to other areas of governance. A risk then is that if investors are over-reliant on proxy agency recommendations, productive innovation in corporate governance may be stifled, and judgement may in effect be outsourced.

Proxy advisors play a valuable role, and their usage should be encouraged as one out of many inputs into a voting decision. Moreover, even if proxy advisors offer consulting services, this need not lead to conflicts if managed appropriately. Thus, the Code should not remove their role, but ensure that it is fully aligned with shareholder interests. The Shareholder Rights Directive is recommending greater transparency for proxy advisors, but only on the main information sources and methodologies applied to lead to their recommendation. This is unlikely to go far enough. Potential principles or provisions for proxy advisors follow below. Some of these mirror the Proxy Advisory Firm Reform Act, introduced in the U.S. House of Representatives in May 2016[6]. Others mirror the BPP, where (similar to the Code) signatories publish statements on their compliance with the principles.

- Proxy advisors should disclose
  - Their consulting activities with companies (potentially including their top clients by revenue), and how they manage potential conflicts that may arise.
  - The nature and extent of the independent review to which they have subjected screening methodologies.
  - Information and cases studies on their approach to voting on current topical issues.

[4] Malenko, Nadya and Yao Shen (2016): 'The Role of Proxy Advisory Firms: Evidence From a Regression Discontinuity Design', *Review of Financial Studies.* Summarised at http://alexedmans.com/how-proxy-advisors-influence-voting-outcomes/.
[5] Li, Tao (2017): 'Outsourcing Corporate Governance: Conflicts of Interest Within the Proxy Advisory Industry,' *Management Science*. Summarised at http://alexedmans.com/conflicts-of-interest-among-proxy-advisors/.
[6] See https://corpgov.law.harvard.edu/2016/05/31/holding-activists-and-proxy-advisory-firms-accountable/ for a summary of the Act.

    - The policies that underpin their voting recommendations.
- Where an assessment of strategic context is essential to determining support for a proposal, this should be clearly highlighted by the proxy advisor to avoid a one-size-fits-all approach.

6. Next Steps

Potential next steps include:

- Reviewing how the Stewardship Code fits in with other market developments such as the FCA Asset Management Market Review and the implementation of the Shareholder Rights Directive.
- Stakeholder testing – we would be happy to help the FRC convene a review constituency drawing on the Purposeful Company Taskforce members, with particular emphasis on getting feedback from a wide range of investors on the practicalities of the new framework and its potential impact on investor behaviour.
- Review of existing Code comply-or-explain Provisions: which should be retained, which should be removed, and how they should be organised against the new Principles.
- Development of best practice Guidance on: for example, collective, individual, and industry engagement.
- Development of guidelines on reporting against the Principles, the comply-or-explain Provisions, and the Guidance.

We would welcome feedback from the FRC to help refine the next phase of development and to understand what support the FRC requires.

The Purposeful Company Steering Group
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Contact Details

Big Innovation Centre
Ergon House
Horseferry Rd
London SW1P 2AL

info@biginnovationcentre.com
www.biginnovationcentre.com

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